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Corporate social responsibility and earnings forecasting unbiasedness ☆

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ABSTRACT

We investigate the relationship between corporate social responsibility (CSR) and I/B/E/S analysts' earnings per share (EPS) forecasts using a large sample of US firms for 1992–2011. Based on literature findings, we decompose the CSR effect into four factors: accounting opacity, corporate governance, stakeholder risk, and overinvestment. We find that all of them significantly affect both the absolute forecast error on EPS and its standard deviation controlling for forecast horizon; number of analysts and forecasts; and year, industry, and broker house effects. Consistently with our ex ante hypotheses, overinvestment, stakeholder risk, and accounting opacity have a positive effect, increasing both dependent variables, while corporate governance quality has a negative effect. A crucial aspect of our findings is that high CSR quality in terms of the four factors (i.e., accounting transparency, high corporate governance quality, stakeholder risk mitigation, and absence of overinvestment) contributes to making earnings forecasts unbiased as unbiasedness is generally met in the subsample of the Top CSR quality companies and markedly violated in the subsample of the Bottom CSR companies. We also document that overinvestment and stakeholder risk are sufficient to produce this effect.

1. Introduction

The aim of this paper is to show that the earnings forecast bias is an interesting unexplored dimension with which it is possible to evaluate the relationship between corporate social responsibility (CSR) and risk.[1] The issue is of great interest today because the role of CSR is growing, as academicians and practitioners explore its impact on corporate performance on different dimensions.[2] While previous research on earnings forecasting has mainly focused on the role of two dimensions of CSR, i.e., accounting and corporate governance, the original contribution of our work to the literature will be its attention to two additional unexplored dimensions, i.e., stakeholders' risk mitigation and overinvestment. More specifically, in our empirical analysis, we calculate the absolute value of the earnings forecast error and its dispersion for high/low-CSR firms to study how CSR affects an ex post measure of risk and uncertainty represented by the distribution of the deviation between ex ante analysts' forecasts and actual ex post released corporate earnings. We use information from one of the most widely adopted CSR scoring standards, that is, the Kinder, Lydenberg, and Domini Research & Analytics, Inc. (RiskMetrics-KLD) rating criteria.[3] As is well known, the RiskMetrics-KLD ratings outline factors of strength and weakness in eight different CSR domains (community, corporate governance, diversity, employee relations, environment, human rights, product quality, and controversial business), giving a positive (negative) score for each of the strengths (weaknesses) for which the firm

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[1] Higher absolute value and dispersion of the earnings forecast error produce, by definition, extra risk in terms of higher uncertainty in predicting firm behavior.

[2] Advertising socially and environmentally friendly behavior, issuing sustainability reports, and hiring CSR experts have become increasingly frequent corporate practices most recently. In 2005, 90% of Japanese companies, 71% of UK companies, and 32% of US companies participated in CSR reporting (KPMG, 2005). The ICCA global report survey (2010) documents that 31% of the top 500 Fortune companies have a separate CSR department. The Nielsen Global Report (2012) calculates that 46% of interviewed consumers are willing to pay more for socially and environmentally sustainable products. Although the willingness to pay for CSR tends to be upward biased, these data and the revealed preferences of market shares of socially responsible products show that the phenomenon is substantial (Carson et al., 2001).

[3] In November 2009, RiskMetrics Group acquired Kinder, Lydenberg, and Domini Research & Analytics, Inc. (KLD). MSCI Inc. acquired RiskMetrics Group Inc. in June 2010. KLD was founded in 1988 as an independent investment research firm providing management tools to professionals, integrating environmental, social, and governance factors (ESG) into their investment decisions.

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qualifies within each domain.[4] In measuring CSR, we follow Goss and Roberts (2011) in distinguishing between CSR strengths which are largely discretionary and weaknesses that are generally exogenous to the firm. Regarding the two previously explored CSR factors (accounting opacity and quality of corporate governance), it may be argued that, if CSR implies greater care for stakeholders, it may also be conceived as positively affecting corporate care in the relationship with analysts and, more generally, as reducing opacity in the communication strategy with the public. More specifically, we know that managers are tempted to manipulate earnings by manipulating accruals (Sloan, 1996; Chaney et al., 2011). For instance, discretionary special charges may be used to inflate corporate results or to avoid the negative signal of non-positive earnings per share to the market. This behavior may generate unpredictable shocks to the "ordinary" process of earnings generation by the firm, thereby creating additional uncertainty and error in analyst forecasts. This is because the forecasting accuracy of analysts is expected to be higher for earnings generated by the ordinary activity of the firm than for end-of-period extraordinary operations used to manipulate earnings. If so, CSR would generate a lower forecast error and a lower dispersion of this error. For our data, accounting accuracy can be measured with the criteria used by the CSR rating company RiskMetrics-KLD to assess corporate CSR weaknesses. More specifically, negative points are assigned if "*The company restated its earnings over an accounting controversy, has other accounting problems, or is involved with some other controversy not covered by other RiskMetrics-KLD ratings*" or if "*The company has been involved in noteworthy controversies on public policy issues and/or has a very poor record of transparency and accountability concerning its political involvement in state or federal level U.S. politics, or in non-U.S. politics*" (see Appendix A).

A second well known potential effect of CSR works through the quality of the corporate governance channel. As is well known, corporate governance is one of the main CSR domains, and some studies suggest that "corporate care" for analysts in the form of management earnings forecasts reduces forecast error. More specifically, Ajinkya et al. (2005) demonstrate that stronger corporate governance, as measured by the greater presence of outside directors and institutional investors, is associated with more frequent and accurate management earnings forecasts. Furthermore, Brown and Zhou (2012) show that analyst forecasts improve after management forecasts. We may therefore measure corporate governance quality as the differences between KLD strengths and weaknesses in this specific domain.

Whereas the role of the first two CSR-related factors has been widely investigated in the earnings forecasts literature, the impact of the other two dimensions (risk mitigation and overinvestment) has received relatively little attention. Goss and Roberts (2011) explain risk mitigation by arguing that low CSR implies externalizing social costs on society and, more specifically, on some groups of stakeholders, thereby generating negative externalities on them. Society understands this occurrence and may impose penalties on firms guilt of it in the past. Goss and Roberts support the risk mitigation finding that firms with fewer concerns received lower loan spreads when they borrow from banks. This hypothesis has a long tradition in the literature. Freeman (1984) argues that CSR may be an optimal choice to minimize transaction costs and potential conflicts with stakeholders. If CSR weaknesses is assumed to minimize transaction costs with stakeholders (and reduce litigation), it consequently addresses an important source of risk (conflicts with stakeholders may translate into significant corporate losses, especially when they lead to class actions), thereby reducing uncertainty and variability of earnings. Judicial trials and litigations are explicitly indicated among factors determining CSR weaknesses (negative points in CSR indicators).[5] Hence, we may reasonably assume that firms with more weaknesses have previously incurred (and are likely to continue to incur) these types of problems, which adds extra uncertainty in analysts' forecasts.[6]

A fourth potential effect of CSR is overinvestment. As is well known, CSR involves a departure from the mono-dimensional and easily verifiable profit maximization goals toward the less clearly measurable target of satisfying a wider range of stakeholders. As a consequence, CSR enhances managerial freedom and may naturally become a domain of arbitrary conduct with the risk of cash flow waste. In this respect, managers may be tempted to overinvest in discretionary CSR strengths to maximize their personal goals of visibility and recognition (so as to increase their prestige or monetize it later by bargaining for higher compensation) at the expense of firm shareholders. The arbitrariness and unpredictability of their behavior may correlate CSR overinvestment with higher forecast errors. Barnea and Rubin (2010) demonstrate that the decision to invest in CSR is negatively related to insider ownership and interpret this finding using the overinvestment hypothesis. In a similar vein, Goss and Roberts (2011) find that banks penalize riskier borrowers which invest in discretionary CSR strengths.

Based on the literature, we address two main questions: whether there is a positive association between shareholder risk (CSR weaknesses) and analyst forecast errors (as predicted by the risk mitigation hypothesis) once the influence of governance and accounting factors (already known) is controlled for and whether the impact of CSR strengths on forecast errors is positive, as predicted by the overinvestment hypothesis. Our empirical findings do not reject these two hypotheses, documenting an impact that is significant and in the expected direction between the two less explored CSR factors (stakeholder risk mitigation and overinvestment) and both measures (absolute value and standard deviation) of the bias, net impact of the other two CSR factors (accounting opacity and quality of corporate governance), standard controls such as the number of analysts, the number of forecasts, four-digit industry dummies, firm size, year, and broker house effects. In terms of economic significance, we however document that the overinvestment effect dominates the stakeholder risk mitigation effect.

An important consequence of our main result is that, if we test unbiasedness in the bottom- and top-performing firms in terms of CSR quality by jointly considering the four factors, we find that it is rejected for the bottom but generally not rejected for the Top CSR firms. The same result is obtained when we define our CSR groups only on the basis of the overinvestment and stakeholder risk factors. Our findings accordingly enrich and complement findings in the earnings forecast error literature documenting the presence of an earnings forecast bias (Nordhaus, 1987) that disappears once

[4] For a detailed description of RiskMetrics-KLD criteria see Appendix A.

[5] In the RiskMetrics-KLD diversity domain, negative CSR points are assigned if "*The company has either paid substantial fines or civil penalties as a result of affirmative action controversies, or has otherwise been involved in major controversies related to affirmative action issues*." In the employee domain, negative CSR points are assigned if "*The company recently has either paid substantial fines or civil penalties for willful violations of employee health and safety standards, or has been otherwise involved in major health and safety controversies*." In the environment domain, negative CSR points are assigned if "*The company has recently paid substantial fines or civil penalties for violations of air, water, or other environmental regulations, or it has a pattern of regulatory controversies under the Clean Air Act, Clean Water Act or other major environmental regulations*."

[6] Note that, in principle, our theoretical prediction of the negative effect of CSR on the earnings forecast bias may also apply to models in which the earnings forecast bias does not contradict rationality. In Lim (2001), a small upward bias represents the optimal choice for analysts who want to acquire a preferential relation with the firms in terms of quality of information received. The demand for preferential treatment may be higher for firms with less accounting transparency or higher shocks due to conflicts with stakeholders. Moreover, low-CSR firms may be more inclined to discriminate among analysts and concede such preferential treatment.